

Winspear Business Reference Room
University of Alberta
118 Business Building
Edmonton, Alberta T6G 2R6



Annual Report

January 31, 1998



HISTORY

Highwood Distillers Ltd. was established in 1974 in High River, Alberta, on the eastern slopes of the Canadian Rocky Mountains. Situated in an ideal grain growing area, with an ample supply of fresh pure water from its own well, Highwood produces, from wheat and rye grains, high quality alcohol, the key ingredient for the Highwood family of fine products.

Highwood became a public company in 1989 with its shares listed for trading on the Alberta Stock Exchange. In 1996, Atlas Concrete Inc. of Calgary became the majority shareholder in Highwood.

Highwood's products are marketed throughout the four provinces of Western Canada. Like its products, Highwood is truly Canadian and uniquely positioned to compete with the multinationals that dominate the Canadian and world-wide spirits industry.

Highwood invites you to enjoy its quality products. Cheers!

DIRECTORS

Jack C. Anderson	President, Cal-Gas Inc.	Calgary
Gerald A. Berkhold	President, Atlas Concrete Inc.	Calgary
Garth M. Farr	Chairman and CEO, White Bear Energy Services Ltd.	Calgary
Ronald L. Graham	Chairman and CEO, Graham Group Ltd.	San Diego
Robert J. Herron	President, White Bear Energy Services Ltd.	Calgary
H. Douglas Hunter	President, RFM Capital Corporation Ltd.	Calgary
William R. Miller	Chairman and CEO, Highwood Distillers Ltd.	Calgary

OFFICERS

William R. Miller	Chairman and CEO
Barry W. Wilde	President
Ronald R. Stothers	Vice-President
Gerald A. Berkhold	Secretary

Distillery

114-10th Ave SE, Box 5693
High River, Alberta T1V 1M7
Phone (403) 652-3202
Fax (403) 652-4227

Calgary Office

Suite 1100, 1015 – 4th St. SW
Calgary, Alberta T2R 1J4
Phone (403) 216-2440
Fax (403) 297-0559

Web Site www.highwood-distillers.com
Email hwdistil@telusplanet.net

Share listing (HDL)

Auditors

Bankers

Lawyers

Alberta Stock Exchange

KPMG

National Bank of Canada

Macleod Dixon



P.O. BOX 5693, HIGH RIVER, ALBERTA, CANADA T1V 1M7
TELEPHONE (403) 652-3202 FAX (403) 652-4227

To the Shareholders of Highwood Distillers Ltd.

Net income for the year ended January 31, 1998 was \$659,210 (\$0.021 per share on a fully diluted basis) as compared with \$18,914 in fiscal 1997. Results for fiscal 1998 contained two unusual items. Firstly, as more fully discussed below, Highwood brought into income the positive impact of \$849,132 resulting from the favorable decision concerning the excise duty previously assessed. Secondly, Highwood recorded a charge of \$135,000 for marketing restructuring.

Sales in the domestic market totaled 92,188 cases, an increase of 3.1% over the previous year. Margins remained constant. With costs satisfactorily contained, income before unusual items and income taxes increased to \$42,078 from \$18,914 in fiscal 1997.

Fiscal 1998 was a year of transition for Highwood, a year in which we have built a sound foundation for future growth. We have strengthened our management team considerably with the addition of Mr. Barry Wilde as President. We developed our own sales force in the Province of Alberta which provides a much closer contact with that dynamic market, the only market in Canada where the retail distribution of spirits has been privatized.

New products have been introduced. Highwood Longshotz, shooters in 20 ml tubes have been introduced in a variety of flavors and have become popular since their introduction in Alberta last fall. They are now also available in Manitoba and Saskatchewan. Highwood Longshotz represent an exciting growth area. Sahara Dry Gin, Centurion Sambuca, and Sweet Sippin' Maple Whisky are being well received in the markets where they are available. Triple Fruit Plus will soon be available.

Labels for most of our products have been upgraded to improve their image and appeal. New packaging is being introduced for our liqueurs. We are very enthused about the quality products representing our expanded and more attractive portfolio.

The many improvements made in our products and methods of sale did not come without a cost. The cost of these changes is discussed in note 12 to the financial statements.

Overall the economies of Western Canada remain strong and the market for distilled spirits continues to expand. In fiscal 1998 we enjoyed a modest, yet meaningful, increase in our overall market share. Conditions continue to be competitive but there are niches to be exploited.

In previous annual reports we have reported on the alleged illegal sales which took place in fiscal 1995. Developments in fiscal 1998 are outlined in note 2 to the financial statements. The most important development related to the Judicial Review heard in the Federal Court of Canada on January 28, 1998. This resulted in an order, issued on February 19, 1998, to set aside the assessment for excise duty received in 1996. The impact of the order is favorable and substantial. However, we have been advised that this decision is being appealed. The appeal will be heard in the Federal Court of Appeal, likely towards the end of 1998.



As the effect to the order is to set aside the assessment, any liability has been changed to a contingent liability. Our counsel and your management are reasonably confident that the order will be upheld. Highwood is seeking to recover payments made on account of the assessment and has eliminated the remaining portion of the liability from its accounts. This has resulted in the net credit to income of approximately \$850,000 before income taxes.

Much has been written and said about the problems which the year 2000 will create for computer based systems and process control systems. As a relatively small company, we do not have the problems which large, complex organizations are working to resolve. The year 2000 will not negatively impact our distilling and bottling operations. We are in the process of installing new software for our accounting requirements which is free of such problems. We will be contacting major suppliers and service providers to determine their status so that any necessary contingency planning can be put in place.

We enter fiscal 1999 with a high level of excitement and confidence in our expanded and attractive portfolio of quality distilled spirits. Our capacity to compete with the multinationals that dominate our industry is quite good. Our size gives us the flexibility to seize opportunities which others cannot.

I acknowledge the dedication and commitment to Highwood which has been demonstrated in so many ways over the past year by our customers, our employees, our sales agencies and our shareholders. Thank you for your support and patience. The Highwood team will be doing their best to make 1999 rewarding for all.

High River
April 8, 1998

On behalf of the Board

A handwritten signature in blue ink, appearing to read "W.R. Miller".

W.R. Miller
Chairman and Chief Executive Officer

MANAGEMENT'S DISCUSSION AND ANALYSIS

Sales

Sales revenue increased during the year ended January 31, 1998 (Fiscal 1998) by 2.9% to \$3,083,040 from \$2,997,397 for the year ended January 31, 1997 (Fiscal 1997). Domestic case sales increased 3.1% from Fiscal 1997. As Fiscal 1997 included export sales the overall increase in case sales was 1.8%. The average price per case sold increased to \$33.44, an increase of 1.0% due to product mix.

Cost of sales and margins

The cost of sales increased with the additional volume and also due to product mix. On a per case basis costs increased to \$20.02 per case an increase of 1.1%. Margins were virtually unchanged at 40.14% in Fiscal 1998 as compared with 40.20 in Fiscal 1997.

Costs

Selling and administrative costs were \$1,018,047 an increase of \$82,276 or 8.8%. The bulk of this increase is "people costs" and represent the cost of building for Highwood's future growth.

Interest costs declined by \$74,842 due to reduced debt and reduced interest rates. Debt was reduced as a result of the decision in the Judicial Review as discussed in note 2(b) to the financial statements. This decision enabled Highwood to eliminate approximately \$42,000 from the interest costs of Fiscal 1998. The issue of shares in late Fiscal 1997 resulted in further debt reduction and thus interest costs in Fiscal 1998.

Income before marketing restructuring, special item and income taxes

The aggregation of marketing restructuring costs and the presentation thereof as a separate charge incurred during Fiscal 1998 has facilitated the comparison of results from normal operations which increased to \$42,078 from \$18,914 in Fiscal 1997. The special item and the marketing restructuring costs have been outlined in some detail in notes 2(b) and 12, respectively, to the financial statements.

Income Taxes

Current income taxes represent the recovery of income taxes paid in fiscal 1992. The basis for recovery of these taxes has been outlined in the third paragraph of note 7 to the financial statements. Deferred taxes include the income tax which will be payable with taxes for Fiscal 1999, resulting from the decision in the Judicial Review discussed in note 2(a) and included for accounting purposes in income for Fiscal 1998. The resulting taxes payable for Fiscal 1999 will be reduced by the benefit of losses carried forward for income tax purposes which total approximately \$700,000 as at January 31, 1998.

Financial Position

As a result of the favourable decision in the Judicial Review (note 2(a)), debt of approximately \$563,000 has been eliminated from Highwood's balance sheet. Furthermore, the impact of this decision on the net income for Fiscal 1999 has enabled Highwood to eliminate its deficit and to show retained earnings of \$308,547.

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

Financial Position (continued)

In addition, the instalment of \$150,000 due December 1, 1997 on the convertible debenture, which was satisfied by the issue of common shares, further strengthened Highwood's capital base. Shareholders' equity has increased to \$1,216,471 which, compared with total long-term debt of \$1,100,000 results in a satisfactory financial position. As Highwood receives the taxes recoverable of \$446,783 at January 31, 1998, bank debt, which stood at \$274,869 as at January 31, 1998, will be eliminated.

It must be acknowledged that the decision in the Judicial Review is being appealed and pending the outcome of that appeal, Highwood has a contingent liability. If the decision is reversed Highwood could be required to repay the amount shown as taxes recoverable of \$446,783 and reinstate debt of approximately \$400,000 pursuant to the 1996 Settlement Agreement with Revenue Canada.

Outlook

Highwood is optimistic about its ability to succeed in the competitive market place for distilled spirits. Labeling has been enhanced and packaging has been improved with greater variety. New products are building excitement.

MANAGEMENTS RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

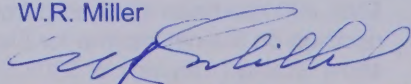
The accompanying financial statements and other financial information have been prepared by the management of Highwood who are responsible for their integrity and objectivity. To fulfil this responsibility, Highwood maintains appropriate systems of internal control and policies and procedures to ensure that its reporting practices and accounting and administrative procedures are of high quality, consistent with reasonable costs, and are designed to provide reasonable assurance that relevant and reliable financial information is produced. These statements have been prepared in conformity with generally accepted accounting principles and, where appropriate, reflect estimates based on judgements of management. The financial information presented throughout this annual report is consistent with the information contained in the financial statements.

KPMG, the independent auditors appointed by the shareholders, have examined the financial statements in accordance with generally accepted auditing standards to enable them to express to the shareholders their opinion on the financial statements. Their report as auditors is set forth on the opposite page.

The financial statements have been further examined by the Board of Directors and its Audit Committee which meets regularly with the auditors and management to review the activities of each. The Audit Committee reports to the Board of Directors. The auditors have direct and full access to the Audit Committee. The Board of Directors, through its Audit Committee, oversees management's financial reporting responsibilities and is responsible for reviewing and approving the financial statements.

High River, Alberta
April 8, 1998

W.R. Miller



Chairman and Chief Executive Officer



KPMG
Chartered Accountants

1200 205 - 5th Avenue SW
Calgary Alberta T2P 4B9

Telephone (403) 691-8000
Telefax (403) 691-8008
<http://www.kpmg.ca>

AUDITORS' REPORT

We have audited the balance sheets of Highwood Distillers Ltd. as at January 31, 1998 and 1997 and the statements of earnings and retained earnings and changes in financial position for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at January 31, 1998 and 1997 and the results of its operations and the changes in its financial position for the years then ended in accordance with generally accepted accounting principles.

Chartered Accountants

Calgary, Canada
April 3, 1998

HIGHWOOD DISTILLERS LTD.

Balance Sheet

January 31

ASSETS

	<u>1998</u>	<u>1997</u>
Current:		
Accounts receivable (note 3)	\$ 134,991	\$ 222,719
Taxes recoverable (notes 2(a) and 7)	446,783	-
Inventories (note 4)	1,548,577	1,570,210
Prepaid expenses	<u>32,265</u>	<u>24,530</u>
Total current assets	2,162,616	1,817,459
Fixed assets, net of accumulated depreciation (note 5)	<u>936,265</u>	<u>971,599</u>
	<u>\$3,098,881</u>	<u>\$2,789,058</u>

LIABILITIES

Current:		
Bank loan (note 6)	\$ 263,240	\$ 93,623
Accounts payable and accrued liabilities	352,170	384,253
Current portion of long term debt (note 8)	<u>150,000</u>	<u>239,000</u>
Total current liabilities	765,410	716,876
Long term debt, net of current portion (note 8)	950,000	1,664,921
Deferred income taxes (note 7)	<u>167,000</u>	<u>-</u>
	<u>1,882,410</u>	<u>2,381,797</u>

SHAREHOLDERS' EQUITY

Share capital (note 9)	907,924	757,924
Retained earnings (deficit)	<u>308,547</u>	<u>(350,663)</u>
Total shareholders' equity	<u>1,216,471</u>	<u>407,261</u>
Contingencies – note 10		
	<u>\$3,098,881</u>	<u>\$2,789,058</u>

See accompanying notes

On behalf of the Board

G.A. Berkhold DirectorW.R. Miller Director

HIGHWOOD DISTILLERS LTD.**Statements of Earnings and Retained Earnings**

Years ended January 31

	<u>1998</u>	<u>1997</u>
Sale of spirits	\$3,083,040	\$2,997,397
Cost of sales	<u>1,845,395</u>	<u>1,792,479</u>
Gross margin	<u>1,237,645</u>	<u>1,204,918</u>
Expenses:		
Selling and administration	1,018,047	935,771
Interest on long-term debt	85,867	137,241
Interest – other	18,314	41,782
Depreciation	<u>73,339</u>	<u>71,210</u>
	<u>1,195,567</u>	<u>1,186,004</u>
Income before the following	42,078	18,914
Marketing restructuring (note 12)	(135,000)	-
Special item (note 2(b))	<u>849,132</u>	<u>-</u>
Income before income taxes	756,210	18,914
Income taxes (recovery) (note 7)		
Current	(70,000)	-
Deferred	<u>167,000</u>	<u>-</u>
	<u>97,000</u>	<u>-</u>
Net income	659,210	18,914
Deficit, beginning of year	<u>(350,663)</u>	<u>(369,577)</u>
Retained earnings (deficit), end of year	<u>\$ 308,547</u>	<u>\$ (350,663)</u>
Net income per share – basic	\$ 0.031	\$ 0.002
- fully diluted	\$ 0.021	\$ 0.002

See accompanying notes

HIGHWOOD DISTILLERS LTD.

Statements of Changes in Financial Position

Years ended January 31

	<u>1998</u>	<u>1997</u>
Cash provided by (used for):		
Operations:		
Net income	\$ 659,210	\$ 18,914
Items not affecting cash:		
Depreciation	73,339	71,210
Deferred income taxes	167,000	-
Loss on sale of fixed assets	<u>3,318</u>	<u>-</u>
	902,867	90,124
Net change in non-cash working capital items:		
Accounts receivable	87,728	(64,649)
Taxes recoverable	(446,783)	355,163
Inventories	21,633	346,594
Prepaid expenses	(7,735)	(22,205)
Accounts payable and accrued liabilities	(32,083)	(68,929)
Income taxes, duty and GST payable	<u>-</u>	<u>(980,000)</u>
	525,627	(343,902)
Financing:		
Issue of common shares	150,000	195,300
Issue of convertible debenture	-	1,250,000
Elimination of debt due to Revenue Canada (note 2)	(653,921)	653,921
Payment on long-term debt	<u>(150,000)</u>	<u>(1,158,370)</u>
	(653,921)	940,851
Investments:		
Purchase of fixed assets (net)	<u>(41,323)</u>	<u>(32,420)</u>
Increase (decrease) in cash position	(169,617)	564,529
Cash position, beginning of year	<u>(93,623)</u>	<u>(658,152)</u>
Cash position, end of year	<u><u>\$ (263,240)</u></u>	<u><u>\$ (93,623)</u></u>

See accompanying notes

HIGHWOOD DISTILLERS LTD.
Notes to Financial Statements

Years ended January 31, 1998 and 1997

1. Significant accounting policies:

The preparation of financial statements, in conformity with generally accepted accounting principles, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses. Actual results could differ from these estimates.

The financial statements represent the accounts of Highwood Distillers Ltd. (Highwood). Its wholly-owned subsidiary, Sunnyvale Trading (Barbados) Inc., which was inactive throughout the 1997 and 1998 fiscal years, was dissolved effective March 13, 1998.

Highwood's significant accounting policies are as follows:

Inventories:

Inventories are valued at the lower of cost and net realizable value. Cost is determined on an average basis and includes raw materials, labour and utility costs associated with production and bottling of spirits. In accordance with industry practice, current assets include spirits which, in Highwood's normal business cycle, are aged for a varying number of years.

Fixed assets:

Fixed assets are recorded at cost. Depreciation is provided using the declining balance method at annual rates as follows (in the year of acquisition 50% of the applicable rate is used):

<u>Assets</u>	<u>Rate</u>
Buildings	5%
Distillery	20%
Office equipment	20%

Bottle molds are depreciated on a straight-line basis at a rate of 10% per annum. The cost of wooden aging barrels, less residual value, is depreciated at 7.5% per annum on a straight-line basis.

Financial instruments:

The carrying amounts of all current assets, except inventories, and current liabilities approximate fair value because of the short maturity of those instruments. The carrying amount for long-term debt approximates fair value due to the floating interest rate on the debt.

Income per share:

Income per share – basic is calculated using the weighted average number of common shares outstanding during the year. Fully diluted income per share assumes the exercise of share purchase options, conversion of convertible debt securities, when dilutive, and reduction of related interest expense.

HIGHWOOD DISTILLERS LTD.

Notes to Financial Statements

Years ended January 31, 1998 and 1997

1. Significant accounting policies (continued):

Deferred Income Taxes

Highwood has adopted the new deferred tax accounting methods prescribed by the Canadian Institute of Chartered Accountants. Pursuant to this method, deferred income taxes represent the income tax payable in the future as a result of including items as income or expense for accounting purposes which will result in an increase or decrease in future taxable income. The tax on the net increase in future taxable income has been computed at current income tax rates.

2. Issues resulting from the alleged illegal sale of spirits:

Following a lengthy investigation, during the year ended January 31, 1996 (Fiscal 1996), criminal charges were laid against two former directors, including the former Chairman of the Board of Highwood in connection with the alleged illegal sale of spirits (the Sales) which occurred during the year ended January 31, 1995 (Fiscal 1995). No such charges were laid against Highwood.

As a result of the Sales, Highwood recorded a special item charging income before income taxes, in Fiscal 1996, with \$1,580,000 being \$980,000 for excise duty and related penalty and interest and GST and \$600,000 for costs incurred, and estimated to be incurred, as a result of the Sales.

During the year-ended January 31, 1997 (Fiscal 1997) Highwood entered into a settlement agreement with Revenue Canada (the Settlement Agreement) pursuant to which, among other things, Highwood agreed to pay the excise duty, and interest to October 31, 1996, as assessed over time and Revenue Canada acknowledged that Highwood would seek a Judicial Review of the excise duty assessment.

During the year ended January 31, 1998 (Fiscal 1998) the following events occurred:

- (a) The Judicial Review was heard in the Federal Court of Canada (the Court) on January 28, 1998. On February 19, 1998 the Court issued an order (the Decision) in Highwood's favor setting aside the excise duty assessment. Highwood was awarded costs, which are being determined, but the recovery will likely be a small fraction of the costs of the Judicial Review incurred by Highwood.

On March 20, 1998 Highwood was informed that the Decision is being appealed. Nevertheless, the assessment of excise duty remains set aside; the liability to Revenue Canada has ceased to exist and Highwood now has a contingent liability (see note 10) dependent on the outcome of the appeal.

Based on the Decision, Highwood is entitled to recover, and is seeking to recover, the payments made or applied in accordance with the Settlement Agreement as follows:

- (i) Income taxes paid in respect of Fiscal years 1992-1995, as a result of the losses for tax purposes incurred in Fiscal year 1995, of approximately \$198,000 as well as the instalments paid on account of Federal income taxes for Fiscal 1996 of \$25,000.

HIGHWOOD DISTILLERS LTD.

Notes to Financial Statements

Years ended January 31, 1998 and 1997

2. Issues resulting from the alleged illegal sale of spirits (continued):

(ii) The instalment paid on account of interest and duty on October 31, 1997 of \$133,000.

(iii) The balance of GST seized in September 1996, which has not been previously recovered, of \$21,000.

In addition the outstanding amount previously shown as a liability in respect of the assessment has been eliminated. This amount, as of January 31, 1998, would otherwise have been \$563,000. Interest previously recorded as an expense in fiscal 1998 has been eliminated from the accounts for Fiscal 1998.

(b) Based on the Decision, Highwood has reversed the expense previously recorded for excise duty and GST related to the Sales. As a result Highwood has brought into income \$849,132 determined as follows:

Excise duty assessed		\$ 722,581
Interest accrued to January 31, 1998		208,123
GST assessed		<u>80,417</u>
		1,011,121
Less:		
GST recovered	\$59,733	
Interest for Fiscal 1998 eliminated from interest costs	42,256	
Additional provision for future expenses re: the Sales	<u>60,000</u>	<u>161,989</u>
Net credit to income		\$ <u>849,132</u>

(c) During Fiscal 1998, Highwood recovered 3075 cases of spirits which had been seized by the authorities in the course of the investigation. In addition subsequent to January 31, 1998 an additional 3187 cases of spirits were returned by authorities which also had been similarly seized by the authorities.

Highwood is continuing to pursue the return of additional spirits held by the authorities. Revenue Canada agreed, in the Settlement Agreement, not to oppose the return of 1600 cases of such spirits which have not as yet been returned.

(d) In Fiscal 1996 Highwood provided \$600,000 in respect of costs incurred, and to be incurred, as a result of the Sales. Changes in this provision during Fiscal 1998 and 1997 were as follows:

HIGHWOOD DISTILLERS LTD.

Notes to Financial Statements

Years ended January 31, 1998 and 1997

2. Issues resulting from alleged illegal sale of spirits (continued):

	<u>1998</u>	<u>1997</u>
Balance of provision, beginning of year	\$ 31,197	\$257,437
Reversal of penalty and related interest re excise duty	-	73,155
Recovery of spirits	48,050	52,499
GST recovered	59,733	-
Additional provision deducted in arriving at the special Item included in the statement of earnings (note 2(b))	60,000	-
Costs incurred	(129,249)	(351,894)
Balance of provision, end of year	<u>\$ 69,731</u>	<u>\$ 31,197</u>

The costs incurred in Fiscal 1998 are, for the most part, represented by legal fees and the value of an officer's time devoted to issues resulting from the Sales and the costs of refurbishing spirits returned by the authorities

The costs incurred in Fiscal 1997 related to the legal and monitor costs associated with an application under the Companies Creditors Arrangement Act as well as other legal costs and the value of officers' time devoted to issues resulting from the Sales.

- (e) Highwood continues to pursue two lawsuits to recover the costs and damages which it incurred as a result of the Sales. These suits are being pursued on a contingency fee basis by counsel. The net proceeds of any settlements have neither been estimated nor recorded in Highwood's accounts.

One of these suits is against the former Chairman of the Board of Highwood, being one of the two individuals referred to in the opening paragraph of this note 2. Highwood is seeking to recover costs and damages, as a result of the Sales. Highwood has obtained a court order attaching the former Chairman's known assets in Canada.

3. Accounts receivable:

Accounts receivable, for the most part, are due from provincial liquor boards.

4. Inventories:

	<u>1998</u>	<u>1997</u>
Finished goods:		
On consignment at a provincial liquor board	\$ 95,004	\$ 64,668
Other	198,133	181,380
Aging inventory	852,736	1,025,550
Supplies and unbottled product	<u>402,704</u>	<u>298,612</u>
	<u>\$ 1,548,577</u>	<u>\$ 1,570,210</u>

HIGHWOOD DISTILLERS LTD.

Notes to Financial Statements

Years ended January 31, 1998 and 1997

5. Fixed assets:

	<u>Cost</u>	<u>Accumulated Depreciation</u>	<u>Net book Value</u>
<u>1998</u>			
Land	\$ 53,885	-	\$53,885
Buildings	686,638	\$ 250,784	435,854
Distillery equipment	790,675	649,589	141,086
Bottle molds	48,014	17,621	30,393
Office equipment	78,404	38,132	40,272
Barrels	<u>241,189</u>	<u>6,414</u>	<u>234,775</u>
	<u>\$1,898,805</u>	<u>\$962,540</u>	<u>\$936,265</u>
<u>1997</u>	<u>Cost</u>	<u>Accumulated Depreciation</u>	<u>Net book Value</u>
Land	\$53,885	-	\$53,885
Buildings	671,716	\$228,237	443,479
Distillery equipment	794,621	621,100	173,521
Bottle molds	48,014	12,819	35,195
Office equipment	48,977	33,545	15,432
Barrels	<u>250,087</u>	<u>-</u>	<u>250,087</u>
	<u>\$1,867,300</u>	<u>\$895,701</u>	<u>\$971,599</u>

6. Bank Loan:

The bank loan is a revolving demand line of credit to a maximum of \$600,000 bearing an annual rate of interest at bank prime plus one percentage point. The bank loan and a contingent liability, in the amount of \$250,000 of the lender to the issuer of a bond held by Revenue Canada (in respect of Highwood's obligations to Revenue Canada), are secured by: (a) a debenture with a first fixed charge covering the distillery plant, inventory and equipment; (b) a floating charge over all other assets; (c) a general assignment of book debts and (d) the guarantee of Highwood's majority shareholder in the amount of \$500,000.

7. Income taxes:

Income tax expense differs from that which would be expected by the application of the combined statutory federal and provincial income tax rates as follows:

	<u>1998</u>	<u>1997</u>
Income before income taxes	\$756,210	\$18,914
Combined income tax rates	44.6%	44.6%
Expected income tax expense	\$337,269	\$ 8,436
Manufacturing and processing credit	(60,496)	(1,513)
Benefit of losses of prior years not previously recognized	(179,773)	(6,923)
Income tax expense - net	<u>\$ 97,000</u>	<u>-</u>

HIGHWOOD DISTILLERS LTD.

Notes to Financial Statements

Years ended January 31, 1998 and 1997

7. Income taxes (continued):

The "special item" included in income, as a result of the Decision referred to in note 2(a), of \$849,132 will be included in taxable income for Fiscal 1999.

The loss for tax purposes for Fiscal 1998 is approximately \$160,000 and the accumulated losses for income tax purposes as at January 31, 1998 total approximately \$700,000. These losses will be applied to reduce the taxable income for Fiscal 1999.

During Fiscal 1998, Revenue Canada assessed Highwood's tax return for Fiscal 1996. As a result certain amounts claimed as an expense in Fiscal 1996 will be claimed for tax purposes in other years including Fiscal 1995. As a result, the revised loss incurred in Fiscal 1995 is being applied to recover income taxes paid in Fiscal 1992 of approximately \$70,000. This amount represents the "Current-recovery" of income taxes included in income.

8. Long term debt:

	<u>1998</u>	<u>1997</u>
Convertible debenture due December 1, 2001, with interest at prime plus two percentage points; repayable at the rate of \$150,000 on December 1 annually and convertible, at the holder's option, at the rate of \$0.10 per share into common shares during the period ending November 18, 1999, and thereafter, at the greater of \$0.10 per share or the market price of the shares.	\$1,100,000	\$1,250,000
Due to Revenue Canada, with interest at rates prescribed from time to time by Revenue Canada. (note 2 (a))	- <u>1,100,000</u>	<u>653,921</u> 1,903,921
Less portion due within one year	<u>150,000</u> <u>\$ 950,000</u>	<u>239,000</u> <u>\$ 1,664,921</u>

The convertible debenture, due December 1, 2001, is secured by the same assets as the bank loan referred to in note 6 subject to the prior interest of the bank.

9. Share capital:

Highwood's authorized capital consists of an unlimited number of common voting shares without nominal or par value and an unlimited number of preferred shares, issuable in series, with rights to be determined upon issuance.

HIGHWOOD DISTILLERS LTD.

Notes to Financial Statements

Years ended January 31, 1998 and 1997

9. Share capital (continued):

The following is a summary of the changes in issued share capital during the years:

	<u>1998</u>		<u>1997</u>	
	Common shares		Common shares	
	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>
Balance, beginning of year	20,725,000	\$757,924	9,975,000	\$562,624
Shares issued:				
For cash less related expenses	-	-	10,750,000	195,300
On conversion of instalment due on debenture	<u>1,500,000</u>	<u>150,000</u>	<u> </u>	<u> </u>
Balance, end of year	<u>22,225,000</u>	<u>\$ 907,924</u>	<u>20,725,000</u>	<u>\$757,924</u>

As at January 31, 1998 1,125,000 common shares have been reserved to be issued pursuant to options granted to directors, officers and employees. A summary of changes in options outstanding is set forth below:

	<u>1998</u>	<u>1997</u>
Number of shares subject to options, Beginning of the year	675,000	925,000
Options terminated	(150,000)	(250,000)
Options granted	<u>600,000</u>	<u> </u>
Number of shares subject to option, End of year	<u>1,125,000</u>	<u>675,000</u>

Details of the options outstanding as at January 31, 1998 are as follows:

<u>Number of shares</u> <u>Subject to option</u>	<u>Number of</u> <u>Shares vested</u>	<u>Price</u>	<u>Expiry</u> <u>Date</u>
375,000	375,000	\$0.20	1998
150,000	75,000	0.17	1999
150,000	75,000	0.16	1999
<u>450,000</u>	<u> </u>	0.14	2002
<u>1,125,000</u>	<u>525,000</u>		

In addition, 11,000,000 common shares have been reserved to be issued in the event that the convertible debenture due December 1, 2001, described in note 8 above, is converted into common shares.

HIGHWOOD DISTILLERS LTD.

Notes to Financial Statements

Years ended January 31, 1998 and 1997

10. Contingencies:

In the event the Decision discussed in Note 2(a) is reversed on appeal, Highwood would be required to record a charge against income in the amount of \$540,000 net of income taxes.

Mr. Philip A. Peterson (Peterson), the former Chairman of the Board of Highwood, has initiated a lawsuit against Highwood seeking approximately \$1.8 million for wrongful dismissal. In a second suit Peterson has increased the amount claimed to \$3.5 million. The second suit relates primarily to the transaction pursuant to which Atlas Concrete Inc. invested \$1,465,000 in Highwood in November 1996, which Peterson claims was prejudicial to his interests. Management believes these suits are without merit and are being vigorously defended. Highwood has filed a law suit against Peterson as stated in note 2(e).

11. Comparative amounts:

Certain amounts for Fiscal 1997 have been reclassified to conform with the method of presentation adopted in fiscal 1998.

12. Marketing restructuring:

During Fiscal 1998 Highwood initiated a major review of its packaging, products and methods of sale. As a result, costs aggregating \$135,000 were incurred for changes which included the design of new labels, which resulted in the replacement of existing labels, writing off obsolete packaging materials and the costs of changing selling methods.

13. Segment information

Highwood operates in one industry, the distilling and marketing of spirits. Substantially all of Highwood's products are sold in Canada.

**The Highwood Family
Of
Fine Products**

Canadian Whisky

*Highwood Canadian Whisky
Centennial Canadian Whisky*

Vodka

*Highwood Vodka
Marushka Vodka
White Lightning Vodka*

Gin

Sahara Dry Gin

Rum

*Highwood White Rum**

Blended Scotch Whisky

*Clanroy**

Tequila

*Old Mexico Tequila**

Liqueurs

*Centurion Sambuca
(it makes Italians envious)
Colita
(an exciting blend of 5 different coffees)
China White
(a smooth white crème de cacao)*

*Sweet Sippin' Maple Whisky
(our best whisky and pure
Canadian Maple Syrup)
Triple Fruit Plus
(a unique blend of black berry,
strawberry, raspberry plus
black current)
Triple Sec
(a wonderful curaco orange flavour)*

Premixes

*Black Russian
(a blend of vodka and Colita)
Long Island Iced Tea
(a refreshing blend of white rum, and tequila
plus gin, vodka and triple sec)
Old Mexico Margarita
(an excellent base for your favourite margarita)*

Highwood Longshotz

*Twelve exciting varieties of single
shot, fun flavoured drinks*

Ask for these products by name at your favorite liquor store, restaurant and bar

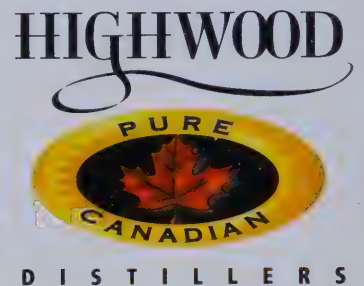
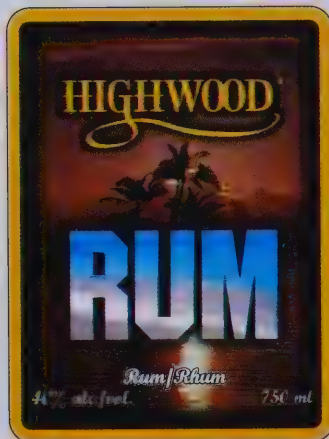
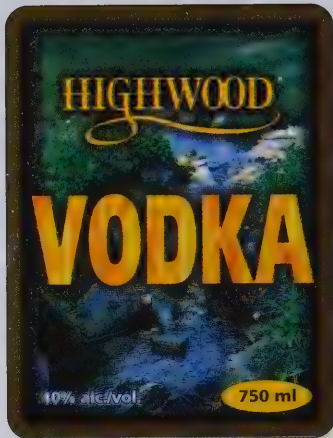
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HIGHWOOD

Vancouver Business Reference Centre
University of Alberta
1-18 Business Building
Edmonton, Alberta T6G 2R6

DISTILLERS 112

Annual Report
December 31, 1998



To the Shareholders of Highwood Distillers Ltd.

We are pleased to report the conclusion of a successful fiscal year for Highwood. As set forth in the third quarter report to shareholders, Highwood has changed its fiscal year-end to December 31 from January 31 effective December 31, 1998.

Sales revenue for the eleven month period ended December 31, 1998 was \$3,707,717, a 20.2% increase over the twelve month period ended January 31, 1998. Case sales showed a 8.9% increase. These percentage gains were achieved despite the shorter reporting period. The greater increase in sales revenue reflects our strategy to emphasize higher value products.

Income, before income taxes, for the eleven month period ended December 31, 1998 was \$244,253 as compared with \$42,078 for the year ended January 31, 1998. For the eleven month period ended December 31, 1998, after income taxes, net income was \$144,253 (\$0.006 per share).

During the prior fiscal year, Highwood brought into income the positive impact of \$849,132, before income taxes, resulting from the favourable decision concerning the excise duty previously assessed. In addition, Highwood recorded a charge of \$135,000 for marketing restructuring. After these items, and income taxes, net income for the year ended January 31, 1998 was \$659,210 (\$0.031 per share).

The results for the eleven month period ended December 31, 1998 reflect the many initiatives undertaken over the last 26 months which began with the investment of \$1,465,000 by Atlas Concrete Inc. in November 1996, accelerated with the strengthening of our management team in 1997 and continues with the enhancement of our packaging and expansion of our product portfolio.

As previously reported, on February 19, 1998, the Federal Court set aside the assessment, levied in 1996 for excise duty and related interest. Revenue Canada appealed this decision, but the appeal was dismissed by the Federal Court of Appeal in December 1998. The period for any further appeal of this decision has now ended. The amount at issue, when this appeal was dismissed, including interest was approximately \$1,000,000. Highwood continues to pursue two other civil actions to recover the substantial costs incurred in respect of those transactions which gave rise to the above mentioned excise duty assessment. All of these costs have been expensed. No amounts have been recorded in respect of possible recoveries.

Much has been written and said about the problems which the year 2000 may create for computer based systems and process control systems. We do not have the problems which large, complex organizations are working to resolve. Based on our continuing examination of this issue, we believe that it should not negatively impact our distilling and bottling operations or our administrative functions. However, Highwood remains at risk in respect of third party suppliers of critical services or goods and the ability of our customers to maintain normal operations. We are contacting these third parties to determine their status so that any necessary contingency planning can be put in place.

Highwood has a solid platform from which to continue its growth. Economic conditions in Western Canada, Highwood's market area, are mixed. Our major market, Alberta, continues to expand in spite of weakness in the natural resource sector. Weak commodity prices are affecting the rest of our market area. Nevertheless, the market for distilled spirits in our market area continues to expand, and our market share is increasing.

For greater growth we must seek new markets. In 1998 we developed a premium vodka, which is being well received, for a California based distributor. Additional orders are expected in the current year. Other markets for Highwood products are being pursued.

In December 1998, Highwood purchased a bottling line for filling Highwood Longshotz shooter tubes and other smaller package sizes. With our growing sales of Longshotz, this is key to improving the cost performance and margins for the product in 1999.

We plan to continue to expand our product portfolio in 1999, to further exploit the niches available to a company of Highwood's size.

The results, which Highwood is now reporting, demonstrate the good taste of our customers, the dedication of our employees and sales agents and the support of our shareholders. We respect and appreciate these qualities.

High River, Alberta
March 18, 1999

On behalf of the Board



W.R. Miller
Chairman and Chief Executive Officer

MANAGEMENT'S DISCUSSION AND ANALYSIS

Sales

Sales revenue increased during the eleven month period ended December 31, 1998 (the Current Period) by 20.3% to \$3,707,717 from \$3,083,040 during the year ended January 31, 1998 (the Prior Year). Case sales increased by 8.9% in the Current Period over the Prior Year. Emphasis on higher value products contributed to the greater increase in revenue than in case quantities.

Cost of sales and margins

Cost of sales increased with additional volume and the added costs associated with higher value products. Gross margin declined by one percentage point to 39.1% in the Current Period primarily as a result of competitive conditions in certain markets.

MANAGEMENT'S DISCUSSION AND ANALYSIS (continued)

Expenses

Selling and administrative costs in the Current Period increased 1.5% to \$1,033,435. Given the increase in sales achieved in the Current Period this nominal cost increase is the result of Highwood's efforts to achieve value for costs incurred.

The on-going costs associated with the alleged illegal sales, as discussed in note 3 to the financial statements, which were incurred in the Current Period, have been charged against the provision previously established as summarized in note 3.

Total interest costs in Current Period are virtually unchanged from the prior year. Interest costs for both long-term debt and the bank loan are based on the bank prime lending rate. The generally higher level of this rate during the Current Period offset the effects of the shorter fiscal period, reduced long term debt and reduced use of the bank line of credit.

Income taxes

The amount of "current" taxes for the Current Period of \$153,000 includes income taxes paid in respect of prior years. This cost has been offset to the extent of \$53,000 by the net change in "future" income taxes provided in the Prior Year. Full details of the many factors influencing current and future income taxes are set forth in note 9 to the financial statements. The income tax provision of the Prior Year was substantially reduced by losses, for income tax purposes, of other years.

Income

The most appropriate comparison of the results for the Current Period with the Prior Year is the comparison of income before income taxes of \$244,253 for the Current Period with \$42,078 for the Prior Year. The "Special item" and the "Marketing restructuring" charge recorded in the Prior Year are commented on in notes 3 and 4, respectively, to the financial statements.

Financial position

In the Current Period, Highwood recovered, in cash, substantially all of the taxes recoverable of \$446,783 as shown on the balance sheet as at January 31, 1998. This enabled Highwood to reduce, and from time to time, to eliminate bank borrowings.

In December 1998, Highwood purchased an additional bottling line to fill Highwood's Longshotz shooter tubes and other smaller bottles. The cost of this machine represents a substantial portion of the investment in fixed assets during the Current Period.

The installment of \$150,000 due on December 1, 1998 on the outstanding convertible debenture was converted into common shares in accordance with the terms of the debenture.

Net income for the Current Period of \$144,253, and the above debt conversion, have increased shareholders equity to over \$1,500,000. This compares very favourably with total long term debt of \$950,000.

Year 2000 issue

Highwood is on schedule to complete its procedures to deal with the year 2000 issue and finalize its contingency planning by June 30, 1999. Both computer hardware and software were recently purchased. In this area, our procedures include necessary testing and obtaining written assurance from the software vendors. Our program of contacting suppliers of critical goods and services, as well as customers, will be completed in the second quarter of 1999.

Our major area of concern is the possible interruption of service by the natural gas utility. Progress of the utility is being monitored. Our contingency planning recognizes this possible problem as well as other potential disruptions which are presently identified. This planning will be revised as necessary as new situations develop.

Outlook

Highwood is Canada's only distillery owned almost entirely by Canadians. It competes with multinational companies which operate on a world wide basis and dominate the Canadian distilled spirits market. Competition is intense. Highwood seeks to be nimble and pursue niche markets with unique quality products as well as offering traditional quality spirits at value pricing.

MANAGEMENT'S RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

The accompanying financial statements and other financial information have been prepared by the management of Highwood who are responsible for their integrity and objectivity. To fulfil this responsibility, Highwood maintains appropriate systems of internal control and policies and procedures to ensure that its reporting practices and accounting and administrative procedures are of high quality, consistent with reasonable costs, and are designed to provide reasonable assurance that relevant and reliable financial information is produced. These statements have been prepared in conformity with generally accepted accounting principles and, where appropriate, reflect estimates based on judgements by management. The financial information presented throughout this annual report is consistent with the information contained in the financial statements.

KPMG LLP, the independent auditors appointed by the shareholders, have examined the financial statements in accordance with generally accepted auditing standards to enable them to express to the shareholders their opinion on the financial statements. Their report as auditors is set forth on the opposite page.

The financial statements have been further examined by the Board of Directors and its Audit Committee which meets regularly with the auditors and management to review the activities of each. The Audit Committee reports to the Board of Directors. The auditors have direct and full access to the Audit Committee. The Board of Directors, through its Audit Committee, oversees management's financial reporting responsibilities and is responsible for reviewing and approving the financial statements.

High River, Alberta
March 18, 1999

W.R. Miller



Chairman and Chief Executive Officer



KPMG LLP
Chartered Accountants
1200 205 - 5th Avenue SW
Calgary AB T2P 4B9

Telephone (403) 691-8000
Telefax (403) 691-8008
www.kpmg.ca

AUDITORS' REPORT TO THE SHAREHOLDERS

We have audited the balance sheets of Highwood Distillers Ltd. as at December 31, 1998 and January 31, 1998 and the statements of earnings and retained earnings and changes in financial position for the eleven month period ended December 31, 1998 and the year ended January 31, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 1998 and January 31, 1998 and the results of its operations and the changes in its financial position for the eleven month period ended December 31, 1998 and the year ended January 31, 1998 in accordance with generally accepted accounting principles.

Chartered Accountants

Calgary, Canada
March 9, 1999



HIGHWOOD DISTILLERS LTD.

Balance Sheets

	ASSETS	
	December 31, 1998 (note 2)	January 31, 1998
Current:		
Cash	\$52,656	-
Accounts receivable	259,149	\$ 134,991
Taxes recoverable	-	446,783
Inventories (note 5)	1,545,036	1,548,577
Prepaid expenses	<u>25,711</u>	<u>32,265</u>
Total current assets	1,882,552	2,162,616
Fixed assets, net of accumulated depreciation (note 6)	<u>1,065,681</u>	<u>936,265</u>
Total assets	<u>\$2,948,233</u>	<u>\$3,098,881</u>

	LIABILITIES	
Current:		
Bank loan (note 7)	-	\$ 263,240
Accounts payable and accrued liabilities	\$299,874	352,170
Income taxes payable	73,635	-
Current portion of long term debt (note 8)	<u>150,000</u>	<u>150,000</u>
Total current liabilities	523,509	765,410
Long term debt due to majority shareholder (note 8)	800,000	950,000
Future income taxes (note 9)	<u>114,000</u>	<u>167,000</u>
Total liabilities	<u>1,437,509</u>	<u>1,882,410</u>

	SHAREHOLDERS' EQUITY	
Share capital (note 10)	1,057,924	907,924
Retained earnings	<u>452,800</u>	<u>308,547</u>
Total shareholders' equity	<u>1,510,724</u>	<u>1,216,471</u>
Contingencies (note 11)		
	<u>\$2,948,233</u>	<u>\$3,098,881</u>

See accompanying notes

On behalf of the Board

"G.A. Berkhold" Director"W.R. Miller" Director

HIGHWOOD DISTILLERS LTD.

Statements of Earnings and Retained Earnings

	11 Months Ended December <u>31, 1998</u> (note 2)	12 Months Ended January <u>31, 1998</u>
Sale of spirits	\$3,707,717	\$3,083,040
Cost of sales	<u>2,256,998</u>	<u>1,845,395</u>
Gross margin	<u>1,450,719</u>	<u>1,237,645</u>
Expenses:		
Selling and administration	1,033,435	1,018,047
Interest on long-term debt	86,652	85,867
Interest – other	17,379	18,314
Depreciation	<u>69,000</u>	<u>73,339</u>
	<u>1,206,466</u>	<u>1,195,567</u>
Income before the following	244,253	42,078
Special item (note 3)	-	849,132
Marketing restructuring (note 4)	<u>-</u>	<u>(135,000)</u>
Income before income taxes	244,253	756,210
Income taxes (recovery) (note 9)		
Current	153,000	(70,000)
Future	<u>(53,000)</u>	<u>167,000</u>
	<u>100,000</u>	<u>97,000</u>
Net income	144,253	659,210
Retained earnings (deficit), beginning of period	<u>308,547</u>	<u>(350,663)</u>
Retained earnings, end of period	<u>\$ 452,800</u>	<u>\$ 308,547</u>
Net income per share - basic	\$ 0.006	\$ 0.031
- fully diluted	\$ 0.006	\$ 0.021

See accompanying notes

HIGHWOOD DISTILLERS LTD.

Statements of Changes in Financial Position

	11 Months Ended December <u>31,1998</u> (note 2)	12 Months Ended January <u>31,1997</u>
Cash provided by (used for):		
Operations:		
Net income	\$144,253	\$ 659,210
Items not affecting cash:		
Depreciation	69,000	73,339
Future income taxes	(53,000)	167,000
Loss on sale of fixed assets	<u>3,570</u>	<u>3,318</u>
	163,823	902,867
Net change in non-cash working capital	<u>354,059</u>	<u>(377,240)</u>
	<u>517,882</u>	<u>525,627</u>
Financing:		
Issue of common shares	150,000	150,000
Elimination of debt due to Revenue Canada	-	(653,921)
Conversion of long-term debt	<u>(150,000)</u>	<u>(150,000)</u>
	<u>-</u>	<u>(653,921)</u>
Investments:		
Purchase of fixed assets (net)	<u>(201,986)</u>	<u>(41,323)</u>
Increase (decrease) in cash position	315,896	(169,617)
Cash position, beginning of period	<u>(263,240)</u>	<u>(93,623)</u>
Cash position, end of period	\$ <u>52,656</u>	\$ <u>(263,240)</u>
Cash position includes cash and bank loans.		

See accompanying notes

Fiscal periods ended December 31, 1998 and January 31, 1998

1. Significant accounting policies:

The preparation of financial statements, in conformity with generally accepted accounting principles, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses. Actual results could differ from these estimates.

The financial statements represent the accounts of Highwood Distillers Ltd. (Highwood). Its wholly-owned subsidiary, Sunnyvale Trading (Barbados) Inc., was inactive in recent years until it was dissolved effective March 13, 1998.

Highwood's significant accounting policies are as follows:

Inventories:

Inventories are valued at the lower of cost and net realizable value. Cost is determined on an average basis and includes raw materials, labour and utility costs associated with production and bottling of spirits. In accordance with industry practice, current assets include spirits which, in Highwood's normal business cycle, are aged for a varying number of years.

Fixed assets:

Fixed assets are recorded at cost. Depreciation is provided using the declining balance method at annual rates as follows (in the year of acquisition 50% of the applicable rate is used):

<u>Assets</u>	<u>Rate</u>
Buildings	5%
Distillery	20%
Office equipment	20%

Bottle molds and wooden aging barrels, less residual value, are depreciated at rates of 10% and 7.5% per annum, respectively, on a straight-line basis.

Net income per share:

Net income per share – basic is calculated using the weighted average number of common shares outstanding during the year. Fully diluted net income per share assumes the exercise of share purchase options, conversion of convertible debt securities, when dilutive, and reduction of related interest expense.

Future Income Taxes

Highwood follows the liability method of recording income tax liabilities whereby future income taxes represent the income tax payable in the future as a result of including items as income or expense for accounting purposes which will result in an increase or decrease in future taxable income. The tax on the net increase in future taxable income has been computed at current income tax rates.

Fiscal periods ended December 31, 1998 and January 31, 1998

2. Highwood changed its fiscal year-end to December 31 from January 31, effective December 31, 1998.
3. Issues resulting from the alleged illegal sale of spirits:

Following a lengthy investigation, during the year ended January 31, 1996 (Fiscal 1996), criminal charges were laid against two former directors, including the former Chairman of the Board of Highwood in connection with the alleged illegal sale of spirits (the Sales) which occurred during the year ended January 31, 1995 (Fiscal 1995). No such charges were laid against Highwood.

As a result of the Sales, Highwood recorded a special item charging income before income taxes, in Fiscal 1996, with \$1,580,000 being \$980,000 for excise duty and related penalty and interest and GST and \$600,000 for costs incurred, and estimated to be incurred, as a result of the Sales.

During the year-ended January 31, 1997 (Fiscal 1997) Highwood entered into a settlement agreement with Revenue Canada (the Settlement Agreement) pursuant to which, among other things, Highwood agreed to pay the excise duty, and interest to October 31, 1996, as assessed, over time and Revenue Canada acknowledged that Highwood would seek a Judicial Review of the excise duty assessment.

The Judicial Review was heard in the Federal Court of Canada (the Court) on January 28, 1998. On February 19, 1998 the Court issued an order in Highwood's favour setting aside the excise duty assessment. This decision was appealed by Revenue Canada. This appeal was heard in the Federal Court of Appeal on December 4, 1998. The appeal was dismissed. Highwood was awarded costs of both actions. The period for any appeal of this decision has terminated.

Highwood recorded the setting aside of the excise duty assessment and its related impact by including a "special item" in earnings for the year ended January 31, 1998 (Fiscal 1998) which consisted of the following:

Excise duty assessed		\$722,581
Interest accrued to January 31, 1998		208,123
GST assessed		<u>80,417</u>
		1,011,121
Less:		
GST recovered	\$59,733	
Interest for Fiscal 1998 eliminated from interest costs	42,256	
Additional provision for future expenses re: the Sales	<u>60,000</u>	<u>161,989</u>
Net credit to income		<u>\$849,132</u>

Fiscal periods ended December 31, 1998 and January 31, 1998

3. Issues resulting from the alleged illegal sale of spirits (continued)

In addition the following events occurred during the eleven month period ended December 31, 1998:

- (a) Amounts paid on account of the excise duty assessment have been recovered and income tax reassessments for all relevant tax years have been settled.
- (b) Highwood has determined that it will not be able to recover any spirits additional to those which were reported as recovered in the annual report for the year-ended January 31, 1998.
- (c) At the beginning of the period Highwood had a provision for future expenses re the Sales of \$69,731 (prior year - \$31,197). During the period, Highwood recovered amounts totalling \$26,262 (prior year - \$107,783). In the prior year, as indicated above, Highwood added \$60,000 to this provision. During the period, Highwood incurred costs totalling \$95,136 (prior Year - \$129,249) which were charged against this provision.
Such costs, in both the period and prior year, consisted, for the most part, of legal fees and the value of an officer's time devoted to issues resulting from the Sales.
The balance remaining in this provision as at December 31, 1998 was nominal (\$69,731 as at January 31, 1998).
- (d) Highwood continues to pursue two lawsuits to recover the costs and damages which it incurred as a result of the Sales. These suits are being pursued on a contingency fee basis by counsel. The net proceeds of any settlements have neither been estimated nor recorded.
One of these suits is against the former Chairman of the Board of Highwood, being one of the two individuals referred to in the opening paragraph of this note 3. Highwood has obtained a court order attaching the former Chairman's known assets in Alberta.

4. Marketing restructuring

During Fiscal 1998 Highwood initiated a major review of its packaging, products and methods of sale. As a result, costs aggregating \$135,000 were incurred for changes which included the design of new labels, which resulted in the replacement of existing labels, writing off obsolete packaging materials and the costs of changing selling methods.

5. Inventories:	December 31,1998	January 31,1998
Finished goods:		
On consignment at a provincial liquor board	\$163,620	\$ 95,004
Other	244,292	198,133
Aging inventory	653,271	852,736
Supplies and unbottled product	483,853	402,704
	<u>\$1,545,036</u>	<u>\$ 1,548,577</u>

HIGHWOOD DISTILLERS LTD.

Notes to Financial Statements

Fiscal periods ended December 31, 1998 and January 31, 1998

6. Fixed assets:

<u>December 31, 1998</u>	<u>Cost</u>	<u>Accumulated Depreciation</u>	<u>Net book Value</u>
Land	\$53,885	-	\$53,885
Buildings	690,291	\$270,844	419,447
Distillery equipment	970,322	679,139	291,183
Bottle molds	48,014	22,021	25,993
Office equipment	100,590	47,412	53,178
Barrels	<u>234,119</u>	<u>12,124</u>	<u>221,995</u>
	<u>\$2,097,221</u>	<u>\$1,031,540</u>	<u>\$1,065,681</u>

<u>January 31, 1998</u>	<u>Cost</u>	<u>Accumulated Depreciation</u>	<u>Net Book Value</u>
Land	\$ 53,885	-	\$53,885
Buildings	686,638	\$ 250,784	435,854
Distillery equipment	790,675	649,589	141,086
Bottle molds	48,014	17,621	30,393
Office equipment	78,404	38,132	40,272
Barrels	<u>241,189</u>	<u>6,414</u>	<u>234,775</u>
	<u>\$1,898,805</u>	<u>\$962,540</u>	<u>\$936,265</u>

7. Bank Loan:

Highwood has a revolving demand line of credit to a maximum of \$600,000 bearing an annual rate of interest at bank prime plus one percentage point. The bank loan and a contingent liability, in the amount of \$250,000 of the lender to the issuer of a bond held by Revenue Canada (in respect of Highwood's obligations to Revenue Canada), are secured by: (a) a debenture with a first fixed charge covering the distillery plant, inventory and equipment; (b) a floating charge over all other assets; (c) a general assignment of book debts and (d) the guarantee of Highwood's majority shareholder in the amount of \$500,000. During the eleven month period Highwood paid a fee of \$5,750 (\$3,818 in the prior year) to its majority shareholder in respect of this guarantee.

8. Long term debt due to majority shareholder:

	<u>December 31, 1998</u>	<u>January 31, 1998</u>
Convertible debenture due December 1, 2001, with interest at prime plus two percentage points; repayable at the rate of \$150,000 on December 1 annually and convertible, at the holder's option, at the rate of \$0.10 per share into common shares during the period ending November 18, 1999, and thereafter, at the greater of \$0.10 per share or the market price of the shares.	\$950,000	\$1,100,000
Less portion due within one year	<u>150,000</u>	<u>150,000</u>
	<u>\$ 800,000</u>	<u>\$ 950,000</u>

The convertible debenture is held by Highwood's majority shareholder and is secured by the same assets as the bank loan referred to in note 7 subject to the prior interest of the bank. Highwood paid interest during the eleven month period on this debenture of \$86,652 (\$85,867 during the previous year).

HIGHWOOD DISTILLERS LTD.

Notes to Financial Statements

Fiscal periods ended December 31, 1998 and January 31, 1998

9. Income taxes:

Income tax expense differs from that which would be expected by the application of the combined statutory federal and provincial income tax rates as follows:

	11 Months Ended December 31,1998	12 Months Ended January 31,1998
Income before income taxes	<u>\$244,253</u>	<u>\$756,210</u>
Combined income tax rates	44.6%	44.6%
Expected income tax expense	\$108,937	\$337,269
Manufacturing and processing credit	(22,750)	(60,496)
Benefit of losses of prior years not previously recognized	-	(179,773)
Other	<u>14,813</u>	<u>-</u>
Income tax expense - net	<u>\$100,000</u>	<u>\$ 97,000</u>

As the result of a court decision released in 1998 in an unrelated tax case, the timing of income tax obligations, resulting from setting aside the assessment of excise duty, as discussed in note 3 above, changed. Consequently, the accumulated losses for income tax purposes, to which reference was made in the financial statements for last year, were applied to reduce the resultant income for tax purposes of prior years.

The significant components of future income tax (assets) and liabilities are as follows:

	December 31,1998	January 31,1998
Excess of depreciation claimed for tax purposes over that recorded in the accounts	\$124,000	\$115,000
Estimated income tax payable after next following fiscal year	-	89,000
Financing costs not yet claimed for tax purposes	(10,000)	(11,000)
Special provision	<u>-</u>	<u>(26,000)</u>
Net total	<u>\$114,000</u>	<u>\$167,000</u>

10. Share capital:

Highwood's authorized capital consists of an unlimited number of common voting shares without nominal or par value and an unlimited number of preferred shares, issuable in series, with rights to be determined upon issuance.

HIGHWOOD DISTILLERS LTD.

Notes to Financial Statements

Fiscal periods ended December 31, 1998 and January 31, 1998

10. Share capital (continued)

The following is a summary of the changes in issued common share capital during the periods then ended:

	<u>11 months ended December 31, 1998</u>		<u>12 months ended January 31, 1998</u>	
	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>
Balance, beginning of period	22,225,000	\$907,924	20,725,000	\$757,924
Shares issued:				
On conversion of instalment due on debenture	<u>1,500,000</u>	<u>150,000</u>	<u>1,500,000</u>	<u>150,000</u>
Balance, end of period	<u>23,725,000</u>	<u>\$1,057,924</u>	<u>22,225,000</u>	<u>\$907,924</u>

As at December 31, 1998 825,000 common shares have been reserved to be issued pursuant to options granted to officers and employees. A summary of changes in shares subject to options outstanding is set forth below:

	<u>11 Months Ended December 31, 1998</u>	<u>12 Months Ended January 31, 1998</u>
Number of shares subject to option, Beginning of the period	1,125,000	675,000
Shares subject to options terminated	(375,000)	(150,000)
Shares subject to options granted	<u>75,000</u>	<u>600,000</u>
Number of shares subject to option, End of period	<u>825,000</u>	<u>1,125,000</u>

Details of the options outstanding as at December 31, 1998 are as follows:

<u>Number of shares Subject to option</u>	<u>Number of Shares vested</u>	<u>Price</u>	<u>Expiry Date</u>
150,000	150,000	\$0.17	1999
150,000	150,000	0.16	1999
450,000	150,000	0.14	2002
<u>75,000</u>	<u>-</u>	0.12	2003
<u>825,000</u>	<u>450,000</u>		

In addition, 9,500,000 common shares have been reserved to be issued in the event that the convertible debenture due December 1, 2001, described in note 8 above, is converted into common shares.

HIGHWOOD DISTILLERS LTD.

Notes to Financial Statements

Fiscal periods ended December 31, 1998 and January 31, 1998

11. Contingencies:

Mr. Philip A. Peterson (Peterson), the former Chairman of the Board of Highwood, has initiated lawsuits against Highwood seeking approximately \$1.8 million for wrongful dismissal and \$3.5 million for damages. Management believes these suits are without merit and are being vigorously defended. Highwood has filed a lawsuit against Peterson as stated in note 3(d).

12. Financial instruments and credit risks

The carrying amounts of all current assets, except inventories, and current liabilities approximate fair value due to the short maturity of those instruments. Accounts receivable are, for the most part, due from provincial liquor boards. The carrying amount for long-term debt approximates fair value due to the floating interest rate on the debt.

13. Uncertainty due to the Year 2000 Issue

The Year 2000 Issue arises because many computerized systems use two digits rather than four to identify a year. Date-sensitive systems may recognize the year 2000 as 1900 or some other date, resulting in errors when information using year 2000 dates is processed. In addition, similar problems may arise in some systems which use certain dates in 1999 to represent something other than a date. The effects of the year 2000 Issue may be experienced before, on, or after January 1, 2000, and, if not addressed, the impact on operations and financial reporting may range from minor errors to significant systems failure which could affect an entity's ability to conduct normal business operations. It is not possible to be certain that all aspects of the Year 2000 Issue affecting the entity, including those related to the efforts of customers, suppliers, or other third parties, will be fully resolved.

14. Segment information

Highwood operates in one industry, the distilling and marketing of spirits. Substantially all of Highwood's products are sold in Canada.

HISTORY

Highwood Distillers Ltd. was established in 1974 in High River, Alberta, on the eastern slopes of the Canadian Rocky Mountains. Situated in an ideal grain growing area, with an ample supply of fresh pure water from its own well, Highwood produces, from wheat and rye grains, high quality alcohol, the key ingredient for the Highwood family of fine products.

Highwood became a public company in 1989 with its shares listed for trading on the Alberta Stock Exchange. In 1996, Atlas Concrete Inc. of Calgary became the majority shareholder in Highwood.

Highwood's products are marketed throughout the four provinces of Western Canada. Like its products, Highwood is truly Canadian and uniquely positioned to compete with the multinationals that dominate the Canadian and world-wide spirits industry.

Highwood invites you to enjoy its quality products. Cheers!

DIRECTORS

Jack C. Anderson	President, Cal-Gas Inc.	Calgary
Gerald A. Berkhold	President, Atlas Concrete Inc.	Calgary
Ronald L. Graham	Chairman and CEO, Graham Group Ltd.	San Diego
H. Douglas Hunter	President, RFM Capital Corporation Ltd.	Calgary
William R. Miller	Chairman and CEO, Highwood Distillers Ltd.	Calgary
Marlin L. Moore	Partner, Moore, Wittman, Phillips	Calgary
Willard H. Yuill	President and CEO, Monarch Communications Inc.	Medicine Hat

OFFICERS

William R. Miller	Chairman and CEO
Barry W. Wilde	President
Ronald R. Stothers	Vice-President
Gerald A. Berkhold	Secretary

Distillery

114-10th Ave SE, Box 5693
High River, Alberta T1V 1M7
Phone (403) 652-3202
Fax (403) 652-4227
e-mail hrplant@telusplanet.net

Web Site www.highwood-distillers.com

Calgary Office

Suite 1010, 1015 – 4th St. SW
Calgary, Alberta T2R 1J4
Phone (403) 216-2440
Fax (403) 234-9609
e-mail hwdistil@telusplanet.net

Share listing (HDL)

Auditors

Bankers

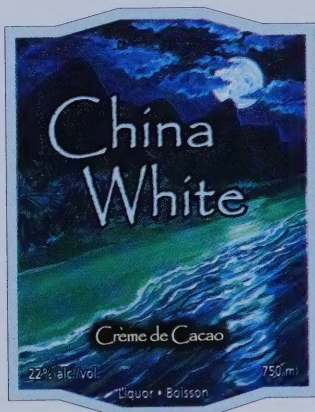
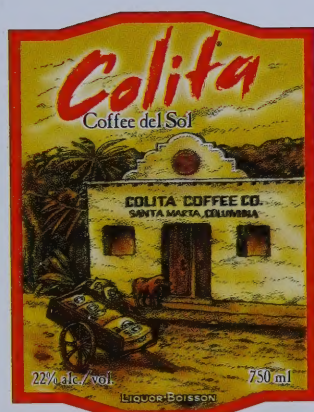
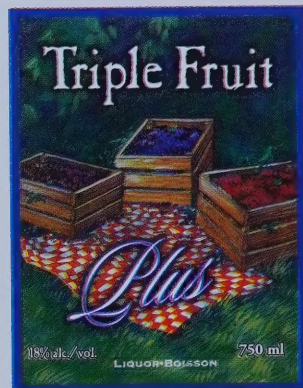
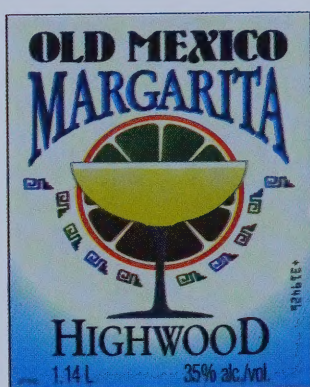
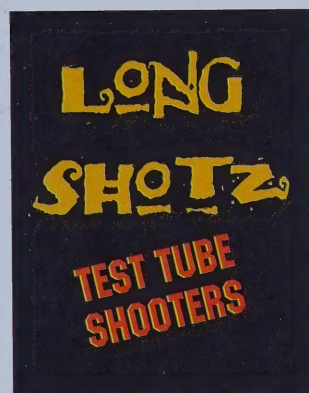
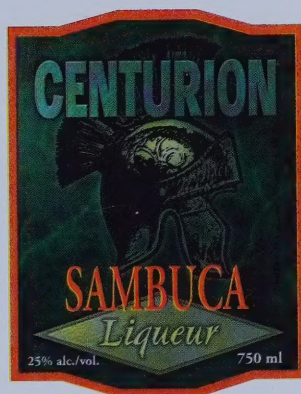
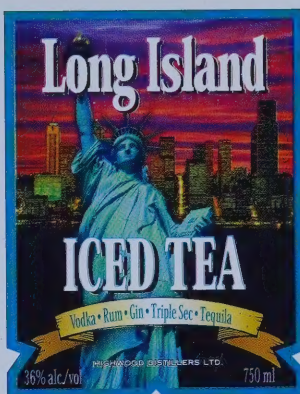
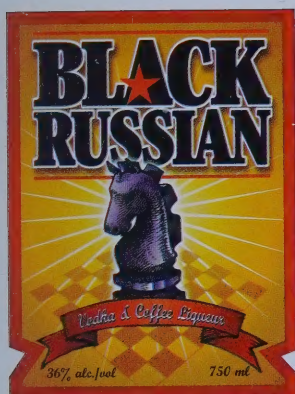
Lawyers

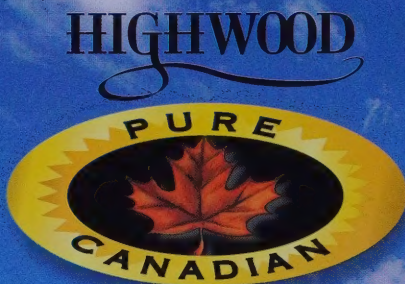
Alberta Stock Exchange

KPMG LLP

National Bank of Canada

Macleod Dixon





The Distillery

114 - 10th Avenue S.E., Box 5693
High River, Alberta, Canada T1V 1M7
Tel: 403-652-3202 • Fax: 403-652-4227
e-mail: hwdistil@telusplanet.net

WWW.HIGHWOOD-DISTILLERS.COM
Alberta Stock Exchange - HDL

The Canadian Prairies

